

Of course, this framework should be embedded within a price cap plan whose parameters have been set at reasonable levels, as discussed *supra*, and from which rate-of-return sharing has been eliminated.

This proposal does not provide completely symmetrical treatment between LECs and other service providers.⁸⁰ Rather, it seeks to provide regulatory protection for consumers where necessary, while affording LECs additional flexibility where that flexibility will benefit consumers through more effective competition. In those limited areas where asymmetric regulation is determined to be necessary to address concerns regarding the possibility of anticompetitive pricing, GTE proposes constraints that deal with these concerns effectively, but with the minimum possible distortion of the competitive outcome.⁸¹

Predictably, other parties, especially current and prospective competitors, have sought in this proceeding to maintain, for as long as possible, constraints that prevent LECs from competing effectively. Some of these parties simply advocate making no changes, despite the fact that the current rules clearly were not designed to deal with either the new technology or the competition that is developing today. Others propose

⁸⁰ In fact, even in the markets found to be most competitive, GTE's proposal would regulate LECs more heavily than other service providers.

⁸¹ *Schankerman* (at 4) discusses the appropriate criteria for adopting an asymmetric regulation. GTE believes that its proposal meets these criteria. *Schankerman* (at 5-11) and *Schmalensee-Taylor* evaluate the possible anticompetitive behavior in which the LEC might engage, and conclude that the GTE proposal represents a reasonable balance between protecting against this behavior on the one hand, while on the other hand allowing customers to benefit from LEC efforts to compete effectively. See, USTA's Comments, Attachment 4, Richard Schmalensee and William Taylor, *Comments on the USTA Pricing Flexibility Proposal*, at 39-40 ("*Schmalensee-Taylor*").

still more constraints on the LECs – constraints designed to advance the interests of these parties, rather than to provide necessary protection to consumers. Far from minimizing the regulatory distortion associated with price caps, some of these proposals will simply prevent LECs from competing effectively. These arguments take a number of forms, which are discussed in turn *infra*.

A. The Commission should establish an adaptive framework in this proceeding.

Several parties have responded to the Notice's request for comment on the state of access competition by simply denying its existence.⁸² These commenters suggest that the Commission should defer any consideration of reform of its rules to accommodate competition and new services.⁸³

These parties' characterizations of the access competition faced by LECs is factually incorrect, as will be shown *infra*. More importantly, these comments mistake the nature of the question facing the Commission in this proceeding. Therefore, debates concerning present or future levels of competition, while useful in developing an understanding of how a framework might be constructed, should not determine whether such a framework is adopted as part of the price cap plan.

The relevant question is simply: should the Commission establish an adaptive framework that accommodates new services and competition? To answer that question in the affirmative, the Commission need only determine that the ability to

⁸² See, AT&T at 8-10, MCI at 65, Teleport at 15.

⁸³ See, MCI at 17-18, Ad Hoc at 17.

accommodate new services and competition is likely to be a relevant policy goal over the next few years. The record in this proceeding clearly supports such a conclusion.

In order to reach this conclusion, the Commission need not determine that any particular access market is competitive today.⁸⁴ GTE suggests that, in fact, a number of access markets would meet any reasonable trigger criteria today. But even putting aside GTE's suggestion and adopting *arguendo* the arguments of commenters that access markets are not competitive, the adaptive framework recommended by GTE would serve the public interest.

Under this adaptive framework, LEC pricing zones would be relabeled as Initial Market Areas ("IMAs"); *i.e.*, the least competitive areas in GTE's proposed market area classification. Until a LEC could demonstrate that a market area within one of its IMAs met the competitive criteria established as part of the framework, there would be no

⁸⁴ The comments in this proceeding provide ample evidence that access competition from a number of sources is developing rapidly, and that significant competitive pressure already exists in many access markets. See, for example, GTE at 23-36 and Attachments B and C, and *Harris. Harris Reply Comments* provide a list of 222 cities in which alternative providers are already operating, and many more where plans for CAP networks have been announced. See, USTA's Reply Comments, Attachment 1, Robert G. Harris, *Reply Report on LEC Price Cap Reforms: United States Telephone Association, ("Harris Reply Comments")*, Table 1. See also NYNEX at 13-18 and Attachment B, SWBT at Appendix COMP. In Houston, 88 percent of SWBT's DS3 demand, and 59 percent of DS1 demand, originates in buildings that are already served by CAPs. (SWBT Appendix COMP at 12) See also, Pacific at 71-106. The two leading CAPs in Los Angeles and San Francisco, already have as much share in the markets they have entered as the entire non-AT&T share of the interexchange usage market. They have achieved this in only four years. (Pacific at 78) Since the record in comments on this issue is extensive, GTE will not summarize it further in these reply comments.

further streamlining of the pricing rules governing that market.⁸⁵ In simple terms, there is no downside to adopting the proposed framework.

If, on the other hand, GTE is shown to be correct, and some markets do meet the criteria in the near term, then customers in those areas would benefit from more effective competition and a wider range of service options. As more markets meet the criteria in the future, they could be streamlined in a timely fashion, with a minimum of delay and cost, and without the need for further proceedings. These are important gains which the Commission could realize for consumers by establishing an adaptive framework.⁸⁶

Finally, the establishment of reasonable ground rules for competition will generate important benefits for all customers — even those in markets which have not

⁸⁵ In fact, as GTE has shown *supra*, consumers in less competitive markets would be protected more effectively than they are under the current plan. More competitive areas would be removed from price caps, and sharing would be eliminated. Therefore, under the proposed plan, the price cap protection customers are afforded in less competitive markets could not be affected by LEC price changes or market losses in more competitive areas.

⁸⁶ The Commission could also make more efficient use of its own scarce resources by establishing a mechanism which is more automatic, and by avoiding the need for a new proceeding every year or two to assess the state of the access market. In a recent study of telecommunications regulation, *Baumol-Sidak* found that rules for LECs, "if they are to be more than transitory, must have considerable flexibility built into them. Because there are areas of activity in the industry in which effectiveness of competition is already claimed, and because almost everywhere competition may well grow and strengthen, rules that are appropriate only for monopoly services may be condemned to very brief lives. Much can be said for the design of regulations with automatic amendment processes that adapt themselves to changing market conditions. Otherwise, it may soon be necessary to redo entirely the costly, protracted, and painful process, now underway in the state regulatory agencies, to determine the rules...." See, William J. Baumol and J. Gregory Sidak, *Toward Competition in Local Telephony*, MIT Press, 1994, at 20 ("*Baumol-Sidak*").

yet met the trigger criteria. It will do this by allowing all providers to base their business decisions on a reasonable expectation of how they will be able to compete. Thus, a LEC would find investment in infrastructure more attractive, because these ground rules will remove the uncertainty that exists today concerning the LEC's ability to introduce new services, vary its prices, and meet customers' specific needs in response to future market entry. Similarly, a Competitive Access Provider ("CAP") or cable company would base its investment decisions not on the expectation that current pricing umbrellas would continue, but on the knowledge that the rules would permit the LEC to respond once certain criteria were met. Commenters who advise the Commission to adopt a "wait and see" approach do not recognize this critically important benefit of establishing a reasonable framework now.

In summary: The Commission should establish in this proceeding an adaptable framework that will adjust the degree of regulation to match the degree of competition in each access market. Because such a framework would streamline regulation only where competition is shown to exist, it would offer great potential advantages to consumers, with no disadvantages. Above all, such rules would establish reasonable expectations upon which all firms, and their customers, could base their market decisions.

B. An adaptive framework should be based on a definition of the relevant market.

Parties claiming that access markets are not competitive⁸⁷ generally provide no relevant information concerning the state of any particular market for access services. In determining whether to make use of an adaptive framework, and in designing such a framework, it is vital that the Commission examine the relevant market for access.

The relevant market is, first of all, the market for interstate access services. While this point may seem obvious, it has apparently been lost on some commenters. AT&T (at 16), for example, presents a list of conditions that must be met before streamlining of access rules can be considered. These conditions deal primarily with the development of competition for local dial-tone service, not interstate access service.⁸⁸ MCI (at 67) presents a similar list. MFS (at 47-49) suggests that the FCC should ask each state commission to certify that MFS' list of conditions for local exchange competition have been met in that state. These proposals are simply attempts to divert the Commission from taking appropriate action with respect to its own regulation of interstate access services.

The issue at hand is whether the Commission should adopt a framework for streamlining its price cap regulation of LEC interstate access services as the markets for these services become more competitive, and how such a plan should be

⁸⁷ See, AT&T at 10-12, MCI at 65, MFS at 38-39, Teleport at 16, ALTS at 13, Ad Hoc at 32-33.

⁸⁸ Since most of these conditions are not relevant to the matter at hand, GTE will not debate their correctness here. Aspects of the market raised by commenters which are relevant to an assessment of access markets will be discussed *infra*.

structured. This issue is separable from issues relating to competition for local exchange services.⁸⁹

First, as many parties have demonstrated, the demand for access services is highly concentrated.⁹⁰ A new entrant does not have to offer local dial-tone service to all of the residence customers in a given area, or even to all the business customers, to compete for a large proportion of the access demand in that area. It should be noted that such an entrant can provide effective market discipline for the incumbent local exchange carrier in the access market, whether or not the entrant chooses to enter the market for local dial-tone service.

Second, the carrier that provides interstate access to a customer need not be the same entity that provides local dial-tone service to that customer. The large customers who generate concentrated demand for access may adopt a number of alternative serving arrangements, which are highly substitutable for one another. The serving arrangement may involve transmitting interstate access demand over the same lines that provide local calling services – those of the LEC, or of another local carrier. Alternatively, interstate access traffic could be carried via a direct connection to an

⁸⁹ Or, perhaps more correctly, local dial tone competition is a sufficient condition, but not a necessary condition, for the existence of access competition in a market area.

⁹⁰ For GTE's domestic telephone operations as a whole, only 6 percent of the end-user customers generate 43 percent of the switched access demand; only .7 percent (seven tenths of one percent) generate 20 percent of the switched access demand. Six tenths of one percent of the end-user customers generate all of the demand for special access channel terminations. And, as the Commission staff's analysis noted, three interexchange carriers order more than 90 percent of the LECs' switched access. *See, Federal Perspectives on Access Charge Reform*, Authored by the Common Carrier Bureau's Access Reform Task Force, dated April 30, 1993, (the "*Staff Analysis*"), at 25-26.

interexchange carrier's Point of Presence ("POP"). These customers are therefore not dependent on any single carrier for their access services; indeed, a customer may choose to divide its access traffic between two carriers in order to assure redundancy.⁹¹

Third, it is clearly possible for an entrant to prosper without being a provider of all local exchange services. Some parties may claim that a CAP cannot compete effectively for the access market unless it can offer a full range of local dial-tone services on the same network.⁹² This claim is contradicted by simple observation of what is occurring in the market today. CAPs are entering new access markets at a dizzying pace, and are growing rapidly in markets they have already entered. Some of

⁹¹ WITel's (at 36) scenario of a "multiple bottleneck" is similarly based on a mistaken view of the nature of the access market. WITel assumes, first, that a customer can be served by only one local carrier, and that the same carrier will provide both local dial tone and interstate access. As GTE has shown here, a customer may choose different carriers for these services, and indeed may split its interstate access traffic between two or more access providers. Second, WITel assumes that a customer will not switch between access providers in order to obtain a better deal on interexchange service. It is already common today for an IXC, or a CAP, or both together, to approach a customer and offer cheaper interexchange service if the customer will purchase access from the CAP. Larger end-users, who generate a large portion of access demand, are already making choices on this basis today; there is no reason to expect that residence customers will not base their choice of dial-tone providers, in part, on the interexchange rates they will obtain as a result.

⁹² See, for example, Teleport at 23, MFS at 39. These commenters also argue that all local markets (including, in Teleport's case, even directory publishing) must be included in a market analysis, since they claim LECs will cross-subsidize access unless all of their other lines of business are fully competitive. If this were really true, then the cable revenues of Teleport's parent, and the construction revenues of MFS's parent, would also be relevant. Two points should be made here: First, non-access services such as local residence service and directory publishing are not substitutable for interstate access, and are therefore not part of the relevant market. Second, these commenters confuse the definition of a market with control of cross-subsidy which is an entirely different issue. GTE discusses *infra* the appropriate safeguards to prevent cross subsidization.

these carriers have focused primarily on the provision of access services to IXCs and large end users.⁹³ Clearly, the managers of these businesses, the customers who are buying their services, and the investors who are financing their expansion, all believe that this business is viable.⁹⁴

For these reasons, issues relating to the entry of new local dial-tone providers, such as number portability or state policies toward these carriers, should not be used to set preconditions for appropriate Commission action in this proceeding. When expanded interconnection was first proposed, it was represented as a means to open access markets to more effective competition.⁹⁵ Now parties are presenting the Commission with new lists of conditions which must be met before the Commission can take action to allow LECs to compete effectively. These are conditions that go beyond interstate access, and many of these conditions would require state action, or are

⁹³ Some CAPs of course, such as MFS, are working rapidly to become full service local providers.

⁹⁴ Of course, roughly two-thirds of the CAP industry is controlled by cable Multiple System Operators ("MSOs"). Many CAP networks are used jointly to provide video services which LECs are prohibited from providing even though they are technically capable of doing so. In fact, it is the LECs, not other providers, which are prevented from using their networks on an integrated basis to provide multiple services. LECs face constraints on their provision of interexchange services, video services, information services, electronic publishing, and CPE.

⁹⁵ MFS stated in its Petition for Rulemaking: "Commission action to enforce economically efficient interconnection of exchange access networks will provide immediate and substantial public interest benefits through enhanced competition, independent of the other initiatives discussed above. As shown in Part IV, below, interconnection will substantially reduce the BOC's ability to leverage control of local exchange bottlenecks into potentially competitive markets, and will therefore assure end users of the full benefit of competitive services at economically rational prices." Petition for Rulemaking, In the Matter of Interconnection of Exchange Access Carrier Facilities, RM-7249, November 14, 1989, at 20.

otherwise based on factors outside the Commission's direct control. The effect is to hold hostage price cap reform. If all of these conditions were met, these parties would doubtless quickly invent yet another list. The effect of these proposals would be to hold interstate price cap reform hostage to state commission decisionmaking without any sound economic grounds for doing so.

In fact, claims of barriers to entry into the local exchange market are overblown. New firms are entering that business today, and many states are actively working to remove any barriers that remain. However, debate over local dial-tone service is outside the scope of this proceeding. There is ample evidence in the record that competition is developing in interstate access markets, and that this development will continue.

Under these circumstances, and in order to accommodate and promote this development, the Commission should immediately establish an adaptive framework for its regulation of interstate access. Further, in designing such a framework, the Commission should establish criteria based on indicators of market power in access markets, rather than on aspects of other markets for local exchange services. GTE and USTA have proposed such criteria.

Further, access markets have a strong geographic component. For a customer who wants access service in one city, it is small comfort to know that alternative supply is available in another city. In fact, the record makes it clear that alternative providers -- while they have not yet entered every market -- are able today to enter any area where there is a sufficient concentration of access demand.⁹⁸ As GTE (at 53-55) shows, for

⁹⁸ See, GTE at 30-31 and Attachment C which provides a list of communities in GTE's serving areas where CAP networks are operating, and where new

competitors using fiber technology, geographic reach is a more useful measure of these firms' capacity to supply service than simple measures of cross-sectional capacity. For these reasons, GTE and USTA have proposed a system of market classification based on small units of geography, and have developed an indicator of market power — addressability — which incorporates a measure of the geographic reach of alternative providers.

Many commenters⁹⁷ agree that access markets are defined by geographic areas, and that the degree of competition varies from one area to another. For example, MCI (at 70) states:

[T]he Commission must recognize that the LEC monopolies are geographically based and that a significant degree of competition in one area has no effect whatsoever on the customers' choices in other LEC serving territories.

Yet these same parties then offer, as evidence of a lack of competition, assertions concerning market share on a national basis which bear no relation whatever to the markets the parties themselves have argued are the relevant ones.⁹⁸

networks are planned. While some of these networks are in large cities, many others are in smaller communities — such as Broken Arrow, OK and Andalusia, AL — where concentrations of access demand exist. USTA's Reply Comments shows that this pattern is common in other LEC serving areas as well. See, USTA's Reply Comments, Attachment 1 by Robert G. Harris ("*Harris Reply Comments*").

⁹⁷ See, MFS at 38-39, MCI at 70, Teleport at 18,27.

⁹⁸ See MCI at 65, Teleport at i, MFS at 39. Aside from the fact that they do not correspond to any relevant access market, there are two other aspects of these market share claims which should be noted here. First, market share is not the appropriate measure of market power. See, GTE at 49-50, *Schankerman* at 18, *Schmalensee-Taylor* at 10-11. Second, the market share numbers cited are wrong. CAP revenue shares, as cited by MCI (at 65), do not include self-supply by IXCs, or access provided by other entities, such as cellular providers, cable

By lumping markets where there is a "significant degree of competition" together with those where such competition has not yet developed, these parties seek to obscure the true state of affairs in any particular market.

The Commission should base its choice of how much regulation to employ in each access market on an assessment of the degree of competition in that market. To aid in this process, GTE and USTA have proposed a framework that applies reasonable criteria to appropriately defined geographic access markets.

Finally, some parties have suggested that the degree of competition should be evaluated, and rules streamlined, separately for individual access services.⁹⁹ These parties again ignore the economic definition of a market.¹⁰⁰ It is well accepted that access services are highly substitutable for one another. Clearly, different bandwidth services, such as DS1 and DS3, are highly cross-elastic. As shown *supra*, customers can readily substitute special access for switched access by adopting different service configurations for their traffic. To the extent that these services are cross-elastic, they are part of a single market.

companies, power companies, microwave, or satellite. They underestimate demand shares because the high-volume segment of the market served by CAPs typically pays access prices lower than the average price. The proportion of access purchased by IXC's, cited by Teleport and MCI, also does not include purchases of access by end-users. NYNEX has estimated its market share for access, for the entire state of New York, at 80-85 percent.

⁹⁹ See, for example, WilTel at 34, Ad Hoc at 33.

¹⁰⁰ These commenters are again inconsistent in that they point the Commission toward the aggregate of all access services, nationwide, when discussing trigger criteria for streamlining. Yet when considering the streamlining itself, they argue that it should apply narrowly to individual services.

It is therefore reasonable to evaluate them together, or at least in broad groupings of services, rather than individually. The rules proposed by GTE and USTA would allow a LEC to make a competitive showing for all of the access services in a market area, or for the subset of those services within a price cap basket.

If the Commission were to examine services individually, it would ignore potentially significant portions of the relevant market for each service. Such an approach would have the effect of distorting relative prices, which would misdirect consumer choices among substitutable services. Further, such an approach would greatly multiply the number of separate evaluations that would have to be performed, introducing delay and giving rise to unnecessary disputes.¹⁰¹ While such delay and complexity might suit LEC competitors, it would not serve the interests of consumers.¹⁰²

In summary: The Commission should base its adaptive framework on a reasonable definition of relevant markets. The relevant market is for: 1) interstate access services; 2) a limited geographic area; and 3) broad groupings of substitutable access services.

¹⁰¹ For example, if individual LEC services are evaluated, it will be necessary to identify which services of competitors are substitutable with the LEC service. This process will be contentious, and open to gaming by competitors, who will naturally claim that their services are "different" from the LEC service. Evaluation of broad service categories will simplify the process, and limit the scope of gaming behavior.

¹⁰² *Schankerman* (at 17) discusses the importance of a correct definition of the relevant market: "Given my emphasis on accessible transport facilities, the geographic market should be defined narrowly." And *Schankerman* (at 18): "Narrow product market definitions are not appropriate from an economic perspective and would subvert the potential for competition created by the new technological flexibility." See also *Schmalensee-Taylor* at 21-25, and *Schmalensee-Taylor Reply Comments* at 3-6.

C. Streamlined regulation should be conditioned on reasonable indicators of market power.

Once the relevant access market has been identified, an adaptive framework should apply an appropriate criterion to determine the extent of LEC market power in that market. In markets where LECs have less market power, regulation should be streamlined accordingly. To be useful in this setting, the indicator employed should provide a reasonable gauge of the LEC's ability to raise and maintain prices above competitive levels. However, to be used regularly in an adaptive framework, without the need for new proceedings, the indicator must also be relatively simple to use.

Addressability, the indicator of LEC market power proposed by GTE, meets these requirements. A market area where a given proportion (25 percent) of the access demand is addressable would be classified as a Competitive Market Area ("CMA"), and afforded the maximum degree of streamlining available within the proposed framework.¹⁰⁹

Several commenters propose the use of different measures of market power. These proposals share one common characteristic -- delay. Each is designed to postpone, as long as possible, the LECs' ability to respond to competition. While this may serve these parties' interest by shielding them from LEC competition for a longer

¹⁰⁹ See, GTE at 55-57 for a discussion of addressability. Attachment 4 to USTA's comments provides a description of how a showing of addressability could be constructed, and the information that would be required. The GTE proposal also incorporates an intermediate level of regulatory treatment. Markets where competitors were present would be designated Transitional Market Areas ("TMAs"), and afforded some limited streamlining of the price cap rules. See, GTE at 58-59.

time, consumers will be denied the benefits they could otherwise have obtained from more effective competition.

A number of parties recommend reliance on market share as a condition for regulatory streamlining.¹⁰⁴ Only in this way, they claim, can the Commission be certain of "actual," rather than merely "potential" competition. AT&T (at 18), for example, proposes that 30 percent of the subscribers in a market area must actually be using alternative providers for local telephone service before streamlining can be considered. It is surprising that AT&T should so starkly contradict its own position, maintained for many years, that market share is irrelevant to a determination of market power in telecommunications.¹⁰⁶

As GTE (at 49) explained, market share does not directly measure market power. Market power depends upon the elasticity of demand faced by the individual firm, which, in turn, depends upon the availability of alternative supply.¹⁰⁶ By measuring the availability of alternative supply, addressability therefore directly measures the crucial determinant of market power.

The competitive alternatives measured by the addressability criterion are not merely "potential." They are real alternatives, available from real providers, with real facilities in place.¹⁰⁷ Consequently, addressability does allow the Commission to base

¹⁰⁴ See, AT&T at 18, MCI at 68-71, WilTel at 35, MFS at 45, Teleport at 17, ALTS at 13.

¹⁰⁵ See, GTE at 53.

¹⁰⁶ See, *Schankerman* at 19-20, *Baumol-Sidak* at 40 and n.18.

¹⁰⁷ In fact, as GTE (at 56) points out, addressability is a conservative measure, because it ignores a portion of the elasticity of supply. In the illustrative showing of addressability described in USTA's Comments, Attachment 9, it is assumed

its decisions on "actual" competition, as many parties recommend. It differs from a market share measure in that it focuses on the aspect of competition that affects the incumbent's market power, which is the availability of alternatives to customers.

By its nature, market share is a backward-looking indicator. Rather than measure the alternatives customers have, it records the choices they have made in response to the alternatives they had in the past. If used as the criterion for streamlining, market share would build in an unnecessary lag between the time an exchange carrier loses market power and the time it would be permitted to respond to competition.

This is the aspect of a market share measure which makes it so attractive to LEC competitors. It also would make such a plan incompatible with the Commission's price cap objectives. By artificially constraining LECs, it would prevent consumers from realizing benefits from effective competition they could have gained had streamlining occurred sooner. Further, as *Schankerman* (at 20) demonstrates, it would not promote efficient investment in the NII, because it would "pick winners" among competing carriers, rather than allowing the market to determine which firm can provide service most efficiently.¹⁰⁸ This, in turn, would lead to losses in technical efficiency. Given the

that an alternative carrier will extend a loop from its backbone network to reach a customer, but the possibility that the carrier will augment the backbone itself is not examined. Thus the analysis looks only at actual backbone facilities, even though it is likely that any attempt by the LEC to raise prices would induce alternative carriers to extend their networks within the market area. The analysis also ignores potential entry by new firms.

¹⁰⁸ As *Schankerman* (at 19) notes the fundamental factor, other than demand elasticity, that determines market share is the relative efficiency of firms. The Commission cannot know these efficiency levels *ex ante*. It must therefore structure rules to treat competing suppliers symmetrically, so that the market can reveal which firms are most efficient. A criterion which conditions movement

large investments that may be necessary to build the NII, these losses could be extremely costly to society.¹⁰⁰

In addition to the fundamental error of relying on market share, AT&T misspecifies its proposal in other ways. It proposes a measure of market share based on the percentage of customers who subscribe to local exchange service from competing suppliers. First, this formula relies on an incorrect specification of the relevant market. As GTE has shown *supra*, competitors need not provide local exchange service at all in order to compete effectively in the interstate access market. Second, the proportion of customers served by competitors is very different from the proportion of demand they may be able to carry. Because access demand is highly concentrated, it is only necessary to provide alternatives to a small percentage of IXC POPs and end user locations to compete for a large proportion of the access demand in a given market. GTE's proposed criterion correctly focuses on the proportion of access demand, rather than access customers, for which alternative supply is available.

The competitors' desire to delay any effective LEC response is most evident in MFS' comments. MFS (at 45) acknowledges that a market share criterion is not reasonable since it would force LECs to lose a specific level of market share before

toward this symmetry on relative market shares may have the perverse effect of penalizing firms which are more efficient, and protecting a given market share for entrants which may be less efficient. Further, as *Schmalensee-Taylor Reply Comments* (at 10) point out, it creates a perverse incentive for the incumbent firm to lose market share. See, USTA's Reply Comments, Attachment by Richard Schmalensee and William Taylor, *Reply Comments: Market Analysis and Pricing Flexibility for Interstate Access Services*, ("Schmalensee-Taylor Reply Comments")

¹⁰⁰ See *Schankerman* at 3, *Schmalensee-Taylor Reply Comments* at 11-12.

being able to price competitively, and because it would be administratively burdensome to measure market share in "thousands of exchange markets throughout the country."¹¹⁰ MFS therefore proposes that the Commission allow pricing flexibility when a long list of preconditions has been satisfied, as certified by the state regulatory authority. GTE has explained *supra* why the FCC's regulation of the interstate access market should not be conditioned on actions in local markets. But MFS (at 49-50) also suggests that LEC flexibility be further delayed – even after all of MFS' preconditions have been met – by as long as two years.

Clearly, both MFS' proposed preconditions and the suggestion of still further delay are merely intended to forestall the day when exchange carriers will be able to compete on more equal terms with MFS. MFS argues that this delay is needed to assure "a reasonable likelihood that competitive services will actually be available." This is incorrect because alternative access services will be available in a market well before MFS' proposal would permit LECs to respond. The addressability criterion proposed by GTE would assure that access alternatives were available to customers in

¹¹⁰ The GTE proposal would be much less burdensome to administer than a market share standard, since it would be necessary to measure only the availability of service, rather than the quantities of service provided – in different forms and by many different providers – in access markets. A discussion of how the necessary information could be gathered with the minimum reporting burden on all carriers is included in USTA's Comments, Attachment 9. It is clear from MFS's statement here that it envisions different regulatory treatment in different geographic markets, on the basis of the level of competition in each area. MFS does not therefore oppose this structural aspect of GTE's proposal, even though MFS (at 15) elsewhere appears to oppose the establishment of "pricing categories" on the basis of the level of competition. Clearly, in MFS' terms, the geographic market becomes a "pricing category" for purposes of determining price cap treatment.

a market before the LEC was granted flexibility there because it measures that availability directly.

D. Pricing rules for each access market should be designed to replicate a competitive market.

GTE (at 1-4) argues that the price cap plan could only achieve its intended purpose of replicating a competitive market result if it established the maximum possible degree of regulatory symmetry. While other parties have professed a desire to ensure a market outcome, they have proposed a variety of asymmetric pricing rules for LEC access services that are designed to produce exactly the opposite effect.

Recognizing that asymmetric regulation may be necessary to correct market asymmetries, *Schankerman* establishes two criteria which any proposed asymmetric regulation should be required to meet:

1. There must be a demonstrated capacity of an incumbent LEC strategically to deter entry; and
2. The proposed regulation must be the least costly way to resolve the potential problem.

The framework proposed by GTE and USTA includes pricing rules that meet these standards. They provide effective protection against any possible abuse of market power in less competitive markets, while allowing LECs to respond to competition where it develops. These proposals are designed to accomplish both of these objectives at the minimum cost -- that is, the minimum distortion from a competitive outcome.

A simple test of the reasonableness of any proposed pricing rule is whether or not it would produce an outcome similar to the one a competitive market would

produce. The objective of replicating a market result is the same in all markets, whether they are actually competitive or not; only the means used to achieve it varies. Pricing rules in less competitive markets must be designed to mimic competition, precisely because competitive forces are not present.¹¹¹

Pricing rules proposed by other commenters do not meet these simple requirements. They are not targeted to correct specific, demonstrable concerns over LEC behavior, but instead are justified by sweeping allegations of LEC sins that are irrelevant, unlikely, or, in some cases, impossible. They are not designed to protect consumers at minimum cost. Indeed, some proposals are designed to prevent, rather than promote, the outcome a competitive market would produce.

Several parties advance the notion that the Commission should increase, rather than streamline, LEC regulation as access markets become more competitive.¹¹² This argument contradicts both economic logic and the Commission's own experience in the interexchange market. LECs can only engage in anticompetitive behavior to the extent that they have market power; as that power is diminished by the availability of competitive alternatives, the need for regulatory constraints is reduced. At the same time, the benefits to consumers of permitting a competitive response by the LECs is increased.

¹¹¹ As *Baumol-Sidak* (at 43) point out: "[T]he object of using this concept (contestability) is to give regulators a model for the design of rules for markets that are distinctly *not* contestable." Therefore, even in markets which are not competitive, "the regulated firm should be left free to pursue any course of action that effective competitive-market forces would have permitted, had they been present." Thus, proposals which clearly preclude efficient prices are inconsistent with effective regulation – regardless of whether competition is present or not.

¹¹² See, *WilTel* at 15, *MFS* at 7.

In the interexchange market, the Commission found it appropriate to streamline regulation of AT&T as competition developed. At a very early stage in the development of interexchange competition -- when AT&T had a more dominant position in the interexchange market than LECs have in some access markets today¹¹⁸ -- AT&T was afforded substantial flexibility to introduce new services and offer volume discounts on both its switched and private line services. The Commission relied on simple safeguards, such as the net revenue test, to guard against specific concerns. It did not find it necessary to require constant markups across services as some parties in this proceeding have proposed. During this period, AT&T's competitors depended heavily on the resale of AT&T's services to complete their own offerings -- much more so than access competitors depend on LEC networks today.

Over the intervening years, the Commission has continued to streamline its regulation of AT&T. In its recent review of AT&T's price cap plan, the Commission has proposed to further reduce the application of price cap constraints to AT&T's services. In its proposal for an adaptive framework, GTE is simply suggesting that the Commission, as it follows the same path for LEC markets, should do so in a systematic

¹¹⁸ See, *AT&T Review*. The FCC notes that AT&T's interstate market share "declined from 64.8 percent in its last quarter of rate of return regulation to 60.7 percent in 1992." *Id.*, 8 FCC Rcd at 6969. As GTE (at 30) noted in its comments, traditional LEC switched access represents a much smaller part of the access market than it once did. In particular, NYNEX has estimated that New York Telephone's switched access market share is only about 40 percent. (GTE at 30 n.37) Further, as *Harris Reply Comments* (at 12) state: "[I]t is impossible to measure the rate of change in market share precisely.... [T]he rate of entry and capital investment in building access and local exchange networks suggests that market shares are changing very rapidly."

way that draws on the interexchange experience, rather than repeating the *ad hoc* series of proceedings that was necessary to establish this policy with respect to AT&T.

Several parties argue that current constraints on LEC pricing should be maintained to prevent LECs from cross-subsidizing competitive services. MFS (at 39) and Teleport (at 23) suggest that LECs could cross-subsidize competitive interstate access services by raising prices of other services. This, suggests Teleport (at 23), "would include access services, local services, intraLATA toll, and associated (tied) services (such as directory assistance, directory publishing)."

In contrast, MCI (at 78) submits that LECs would raise access rates to cross-subsidize local services. None of these claims are based on reasonable expectations of what LECs would actually do. Further, the remedies proposed conflict with other Commission goals in this proceeding. They do not protect against possible cross-subsidy efficiently, or at minimum cost in terms of market distortion.

Most of the services provided over LEC networks are intrastate in nature and are regulated by state commissions. There is no mechanism that would permit a LEC to recover revenue lost through a reduction in interstate access rates by raising rates for these intrastate services. In fact, if there is a support flow between the jurisdictions, it is from interstate access services, which have traditionally had relatively high levels of contribution, to local exchange services where low rates kept contribution levels low.¹¹⁴

¹¹⁴ See, *Staff Analysis* at 53-54. This does not mean, however, that MCI's claim has merit. Competitive pressure has been forcing access prices downward. GTE has reduced its access rates by \$.7 billion over the three-year review period. GTE's rates are well below their caps in many areas — not only for special access, but for common line and traffic sensitive rates as well. MCI here makes the same error as WilTel: assuming that a local provider could maintain market power over access services in the face of competition from other local providers.

With respect to cross-subsidy from one interstate access market to another, the appropriate pricing rules are straightforward and are included in GTE's proposal: price floors for more competitive markets and effective caps for access prices in less competitive markets. In order to protect consumers -- rather than competitors -- it is neither necessary nor appropriate to maintain constraints that prevent LECs from competing effectively in more competitive markets as some parties propose.¹¹⁵

Nor is it beneficial to develop still more restrictive pricing rules, such as the "cost consistency" plan proposed by MFS (at 3-4), which would impose on LECs and their customers inefficient rates that a competitive market would not produce.¹¹⁶ Unlike these plans, GTE's proposal provides effective, targeted protection, while minimizing any distortion of the competitive market result. This is achieved:

First, by establishing a floor of Long-Run Incremental Cost ("LRIC") under every price. The GTE proposal ensures that no rate can be receiving a cross-subsidy. As *Baumol-Sidak* observe: "Both cross-subsidy and predatory pricing, by their very nature, can be prevented by adopting suitable floors under prices."¹¹⁷

As GTE has shown *supra*, consumers, in selecting their local carrier, will consider the effect of their choice on the long distance rates they will pay.

¹¹⁵ See, for example, Teleport at 14.

¹¹⁶ See, MFS at 17. The problems with this proposal will be discussed in greater detail *infra*.

¹¹⁷ *Baumol-Sidak* at 63-64. GTE will discuss *infra*, in the context of new service pricing rules, why Long Run Incremental Cost ("LRIC") is a more reasonable floor for individual rate elements than the Total Service Long Run Incremental Cost ("TS-LRIC") standard proposed by several commenters. See also *Schankerman* at 10. *Schmalensee-Taylor* (at 16) say: "So long as carrier access prices in more competitive markets remain above incremental cost, pricing flexibility that permits price reductions to match competition is procompetitive, not anticompetitive."

Second, by establishing effective ceilings on services in less competitive markets in the form of price caps. The GTE proposal prevents a LEC from raising prices in less competitive markets to fund rate reductions in more competitive markets. Further, by eliminating sharing and the low-end adjustment mechanisms, GTE's proposal ensures that the caps in less competitive markets cannot be affected by LEC pricing decisions in more competitive markets. As *Schankerman* observes: "Access reform of this type delinks price determination in monopoly and competitive markets (for each service basket) and thereby removes the opportunity for entry-deterring cross-subsidization."¹¹⁸

GTE's proposal delinks price determination between markets on a geographic basis, as MFS (at 55) itself suggests, rather than between individual services within each market.¹¹⁹ The proposal also maintains, in all but the most competitive markets, price cap baskets on a functional basis -- a feature which MFS (at 15-16) also supports. This means that relative price movements in these markets will continue to be limited by banding constraints as well as basket caps.

¹¹⁸ *Schankerman* at 11. *See also Schmalensee-Taylor* at 17: "To the extent that non-competitive services are isolated from competitive services under the price cap, lowering competitive services bestows no additional ability to raise non-competitive prices to offset losses."

¹¹⁹ Teleport at 19 argues incorrectly that switched access elements, such as local switching and the Carrier Common Line ("CCL"), are not subject to competition. MCI at 73 similarly claims that there is no competition for either switching or local loop services. In fact, alternative carriers are providing those services today. More importantly for the near term, switched and special access are highly substitutable for customers who have competitive alternatives available. This is why GTE has reduced prices, and priced below its cap, for switched access services as well as special. It is also why, under GTE's proposal, LECs are able to demonstrate the presence of competition for all access services within a geographic market.

In summary: The adaptive framework proposed by GTE will provide effective protection for consumers against possible anticompetitive pricing behavior by LECs. It will afford this protection at the minimum possible cost in terms of distortion from the efficient outcome a competitive market would produce.

E. The Commission should reject proposals to further limit pricing flexibility based on specific costing methodologies

Several commenters maintain that increased pricing flexibility will lead to unreasonable discrimination across LEC services and customers, and these parties seek to further constrain the limited pricing flexibility now available to the LECs. MFS (at 3-4) proposes a "cost consistency test" as a requirement for rate elements in the trunking basket and for new services. This "cost consistency test" would limit prices for services to their long-run incremental cost with a +/- ten percent movement based on the "average price to cost ratio" of the basket. WilTel (at 30-33) recommends uniform markups over LRIC based on uniform overhead allocations across all services. These proposals should be rejected for a number of reasons.

First, GTE's proposal would provide streamlined pricing rules only where, and to the extent, it is demonstrated that customers have alternative choices available. In these markets, competitive pressure will ensure that rate relationships are reasonable. In less competitive markets, price cap basket and band constraints will remain.¹²⁰

¹²⁰ MFS (at 9) states specifically that the discrimination with which it is concerned is "between those customers who may have effective competitive alternatives and those who do not." Therefore, regulation which provides flexibility conditional on the availability of competitive alternatives meets MFS' concerns. MFS (at 11) also concedes that "If competitive markets are to operate efficiently and produce consumer benefits, then, at that time, LECs in those markets must have the same flexibility with respect to prices and services and the same market incentives (both rewards and risks) as do their competitors."